DEPARTMENT OF STATE REVENUE

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Letter of Findings: 02-20110225
Indiana Corporate Income Tax
For the 2006 Tax Year

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ISSUES

I. Corporate Income Tax–Net Operating Losses.

Authority: IC § 6-3-2-2.6 (as amended effective 2004); IC § 6-3-2-12; IC § 6-3-4-6; IC § 6-8.1-5-1; IC § 6-8.1-9-1; Kraft General Foods, Inc. v. Iowa Dep't of Revenue and Finance, 505 U.S. 71 (1992); Phoenix Coal Co. v. Comm'r, 231 F.2d 420 (2d Cir. 1956).

Taxpayer protests that the Department erred in calculating its available net operating loss deductions.

II. Corporate Income Tax–Exclusion of Entity.

Authority: IC § 6-3-2-2; IC § 6-3-4-14; IC § 6-8.1-5-1; 45 IAC 3.1-1-111; Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999).

Taxpayer protests the Department's decision to exclude one of its subsidiaries from its consolidated income tax return.

STATEMENT OF FACTS

Taxpayer is a parent corporation doing business in Indiana and other states. Taxpayer files its Indiana adjusted gross income tax returns on a consolidated basis with its subsidiaries. Pursuant to an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed additional adjusted gross income tax for the 2006 tax year. Taxpayer filed its 2006 Indiana corporate income tax return reporting an Indiana net operating loss deduction from net operating losses carried forward from the 2001 and 2003 tax years. The Department determined that Taxpayer had incorrectly reported its net operating loss deduction for the 2006 tax year. The Department determined that, due to its untimely reporting of the adjustments from the Internal Revenue Service, the amount of loss from the 2001 tax year to be carried forward was limited. In addition, the Department determined that Taxpayer had otherwise incorrectly calculated the amount of net operating loss deductions available from losses originating in the 1999, 2001, and 2003 tax years. The Department also determined that Taxpayer had included an out-of-state subsidiary in its consolidated Indiana adjusted gross income tax returns that did not have Indiana source income and excluded the subsidiary from the consolidated returns. Taxpayer protested these adjustments. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as required.

I. Corporate Income Tax–Net Operating Losses.

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

The Department determined that Taxpayer had incorrectly computed its available net operating loss deduction for the 2006 tax year.

IC § 6-3-2-2.6(c)-(d) provides the calculation of a corporation's Indiana net operating loss, as follows:

(c) An Indiana net operating loss equals the taxpayer's federal net operating loss for a taxable year as calculated under Section 172 of the Internal Revenue Code, derived from sources within Indiana and adjusted for the modifications required by IC 6-3-1-3.5.

(d) The following provisions apply for purposes of subsection (c):

(1) The modifications that are to be applied are those modifications required under IC 6-3-1-3.5 for the same taxable year in which each net operating loss was incurred.

(2) The amount of the taxpayer's net operating loss that is derived from sources within Indiana shall be determined in the same manner that the amount of the taxpayer's adjusted income derived from sources within Indiana is determined under section 2 of this chapter for the same taxable year during which each loss was incurred.

(3) An Indiana net operating loss includes a net operating loss that arises when the modifications required by IC 6-3-1-3.5 exceed the taxpayer's federal taxable income (as defined in Section 63 of the Internal Revenue Code), if the taxpayer is a corporation, or when the modifications required by IC 6-3-1-3.5 exceed the taxpayer's federal adjusted gross income (as defined by Section 62 of the Internal Revenue Code), if the taxpayer is a nonresident person, for the taxable year in which the Indiana net operating loss is determined.

A. Foreign Source Dividends.

Taxpayer asserts that it calculated its net operating loss deduction originating from the 1999, 2001, and 2003

tax years correctly when it included the deduction found in IC § 6-3-2-12 in the computation.

IC § 6-3-2-12(b), provides:

A corporation that includes any foreign source dividend in its adjusted gross income for a taxable year is entitled to a deduction from that adjusted gross income. The amount of the deduction equals the product of:

(1) the amount of the foreign source dividend included in the corporation's adjusted gross income for the taxable year; multiplied by

(2) the percentage prescribed in subsection (c), (d), or (e), as the case may be.

Accordingly, IC § 6-3-2-12 allows a taxpayer to take a deduction from its Indiana adjusted gross income for certain foreign source dividend income that has been included in that taxpayer's Indiana adjusted gross income.

The foreign sourced dividends deduction is a specific deduction from Indiana adjusted gross income. However, there is no similar statutory provision for such a deduction in the computation of an Indiana net operating loss deduction. As provided above, the Indiana net operating loss deduction begins with federal adjusted gross income and is modified according to the Indiana statute. The foreign source dividends deduction is not one of the modifications allowed by IC § 6-3-2-2.6 in arriving at the Indiana net operating loss deduction. Therefore, Taxpayer's inclusion of the foreign source dividends deduction in the computation of its net operating loss deduction is contrary to IC § 6-3-2-2.6.

Taxpayer asserts that the Department, by not including the foreign sourced dividends deduction in the net operating loss deduction calculation, is taxing foreign source dividends. However, the Department is not taxing the foreign sourced dividends. The foreign sourced dividends deduction is a deduction from Indiana adjusted gross income that is allowed to a Taxpayer when appropriate. In this case, the Department has simply properly calculated a new deduction allowed the Taxpayer under IC § 6-3-2-2.6. Taxpayer's approach would result in compounding the deductions upon one another. Taxpayer has not referenced any statute or regulation which requires the Department, or allows the Taxpayer, to do so. Taxpayer, therefore, invites the Department to exceed the statutory authority IC § 6-3-2-2.6.

Additionally, Taxpayer maintains that IC § 6-3-2-2.6 discriminates against foreign commerce in violation of the United States Constitution. Taxpayer cites to Kraft General Foods, Inc. v. Iowa Dep't of Revenue and Finance, 505 U.S. 71 (1992) to support its assertion. However, Taxpayer's situation is distinguishable from the Kraft case. Unlike the Iowa statutes in Kraft that did not provide for a foreign source dividends deduction, Indiana statutes have a deduction for foreign source dividends. Moreover, in Kraft the Court recognized this distinction among states and that "Iowa could enjoy substantially the same administrative benefits by utilizing the federal definition of taxable income, while making adjustments that avoid the discriminatory treatment of foreign subsidiary dividends. Many other states have adopted this approach." Id. at 81, n. 24. In fact, Indiana was included in the list of fifteen states that have taken this approach. See Id. 81, n. 24 (referencing the appendix to Kraft's petition for writ of certiorari that contains the list of fifteen states). Thus, the analysis in Kraft actually supports the Department's assessment. Notwithstanding, an administrative hearing conducted by the Department of Revenue is not the proper forum to determine the constitutionality of an Indiana statute.

Therefore, Taxpayer's protest of the imposition of tax resulting from the Department's determination of its available 2006 tax year net operating loss deduction–by not including the foreign sourced dividends deduction in the net operating loss deduction calculation for the net operating losses carried forward from the 1999, 2001, and 2003 tax years–is denied.

B. RAR Adjustments.

Taxpayer asserts that also it calculated its 2006 tax year net operating loss deduction originating from a loss in the 2001 tax year correctly when it included the additional net operating loss deductions arising from the effects of adjustments from the Internal Revenue Service ("RAR") for the 2001 tax year.

Originally, the Department determined that Taxpayer had incorrectly computed the amount of available net operating loss deduction for the 2006 tax year, due to its failure to timely report its RAR adjustments limiting the amount of loss available from the 2001 tax year to be carried forward. As explained in IC § 6-3-4-6(c), "If the federal modification results in a change in the taxpayer's federal or Indiana adjusted gross income, the taxpayer shall file an amended return within one hundred twenty (120) days after the modification is made." Once notified of the adjustment, the taxpayer is required to submit to the Department any resulting Indiana refund claim within six months. "If a taxpayer's federal income tax liability for a taxable year is modified by the Internal Revenue Service, and the modification would result in a reduction of the tax legally due, the due date by which the taxpayer must file a claim for refund with the department is the later of: (1) the date determined under subsection (a); or (2) the date that is six (6) months after the date on which the taxpayer is notified of the modification by the Internal Revenue Service." IC § 6-8.1-9-1(f). Thus, the statute of limitations for the amended return was the later of three years from the original return's due date or six months from the Internal Revenue Service's June 2004 issuance of the RAR modifications.

Taxpayer admits that it failed to the file the amended returns for the 2001 tax year within the statute of limitations. Taxpayer, however, maintains that its failure to file the return did not prevent Taxpayer's use of the RAR adjustments to increase its available net operating loss deductions for any year in which the statute of limitations was open and it filed an amended return for the open year properly reflecting the additional available

net operating loss deduction.

While Indiana statutes and case law have not dealt with this particular situation, federal law governing net operating losses has dealt with this situation. In Phoenix Coal Co. v. Comm'r, 231 F.2d 420 (2d Cir. 1956), the court held that the income for a closed year could be recomputed to determine the proper amount of net operating loss allowed to be carried to an open year. Id. at 421-422. The court reasoned that even though additional taxes could not be assessed for the closed year, the net operating loss from the closed year effects an open year and as such can be recomputated to determine the correct tax liability for the open year. Id.

Since Taxpayer is not asking for a refund of tax for a closed year(s) and is using the RAR information to determine the effect of the net operating loss deduction for an open year, Taxpayer may use the RARs adjustments to determine the available net operating loss deduction for the open year. Therefore, Taxpayer's protest is sustained in part subject to the results of a supplemental audit. Taxpayer is instructed to file, within 30 days of the issue date of this Letter of Findings, an amended return for the 2001 tax year reflecting the changes from the RAR adjustments. This return shall be used for informational purposes to assist the Department in its determination of the amount of net operating loss available for use as a net operating loss deduction for the 2006 tax year. The audit division is requested to review this information and perform a supplemental audit.

FINDING

Taxpayer's protest to the imposition of tax resulting from the Department's determination of its available 2006 tax year net operating loss deduction, by not including the foreign sourced dividends deduction in the net operating loss deduction calculation for the net operating losses carried forward from the 1999, 2001, and 2003 tax years, is denied, as discussed in subpart A. Taxpayer's protest to the imposition of tax resulting from the determination of its available 2006 net operating loss deduction that originated from an additional amount of net operating loss carried forward from the 2001 tax year, as the result of an RAR, is sustained in part, subject to the results of a supplemental audit, as discussed in subpart B.

II. Corporate Income Tax–Exclusion of Entity.

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

The Department removed one of Taxpayer's out-of-state subsidiaries that did not have Indiana source income from Taxpayer's consolidated adjusted gross income tax returns. The subsidiary was excluded from the returns because it did not meet the Indiana source income requirement found in IC § 6-3-4-14. The out-of-state subsidiary reported zero Indiana property, payroll, and sales.

Pursuant to IC § 6-3-4-14(a)-(b), "[A]n affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3... with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana." (Emphasis added). This is further explained in 45 IAC 3.1-1-111, which states in relevant part:

> The Adjusted Gross Income Tax Act adopts the definition of "affiliated group" contained in Internal Revenue Code section 1504, except that no member of the affiliated group may be included in the Indiana return unless it has adjusted gross income derived from sources within the state, as that phrase is defined in IC 6-3-2-2. For purposes of this subsection, "Adjusted Gross Income derived from sources within the state" means either income or losses derived from activities within the state.

IC § 6-3-2-2(a), in relevant part, defines "adjusted gross income derived from sources within Indiana," as follows:

> (1) income from real or tangible personal property located in this state;
> (2) income from doing business in this state;
> (3) income from a trade or profession conducted in this state;
> (4) compensation from a trade or profession conducted in this state; and
> (5) income from stocks, bonds, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.
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> In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. **In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana....**
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> (b) Except as provided in subsection (l), **if business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from sources without the state of Indiana, the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by a fraction**, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three (3)....
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> **(Emphasis added).**

Accordingly, when a taxpayer has business income that is earned from sources within and without Indiana, it is only the amount of the business income that is apportioned to Indiana that is deemed to be derived from Indiana sources. Thus, a taxpayer only has business income from Indiana sources to the extent that it has Indiana property, payroll, or sales factors found in IC § 6-3-2-2(b). Therefore, since the out-of-state subsidiary has zero Indiana property, payroll, and sales factors, the subsidiaries' business income times zero results in the subsidiary having no income that is derived from Indiana sources.

In Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999), the Department removed three corporations from the taxpayer's return because the corporations did not have Indiana source income, which meant the corporations did not have nexus with the state for adjusted gross income tax purposes. The Tax Court found, as follows:

> [Since] neither of the three corporations had any Indiana property, payroll, or sales factors during the tax years at issue..., none of three corporations had adjusted gross income derived from sources within Indiana, a statutory prerequisite to filing a consolidated return. Accordingly, the Department properly removed these corporations from Hunt's consolidated returns.
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> Id. at 781.

The Tax Court explained:

> [W]hen dealing with business income, one does not attempt to determine the source of a particular item of income. Rather, business income is apportioned based on the property, payroll and sales factors of the corporation. See IND.CODE § 6-3-2-2(b) (Supp.1985). Therefore, if a corporation has no Indiana sales, payroll or property, then the corporation has no adjusted gross income derived from sources within Indiana, unless, of course, the corporation has non-business income allocable to Indiana. See id. § 6-3-2-2(a) (Supp.1985) ('In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection [6-3-2-2](b) shall be deemed to be derived from sources within the state of Indiana.').
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> Id.

Accordingly, in Hunt the Tax Court affirmed that to be included in the consolidated return the entity would have to have Indiana apportionment factors to have business income from Indiana sources or have nonbusiness income sourced to Indiana.

During the course of the protest, Taxpayer asserted that since the managers of the out-of-state subsidiary were the same as the Indiana parent corporation, the out-of-state subsidiary had a commercial domicile in Indiana. Taxpayer maintains that the out-of-state subsidiary's Indiana commercial domicile created nexus in Indiana. In effect, Taxpayer is asserting that the out-of-state subsidiary–which has no payroll, property, or sales of their own in Indiana–can acquire nexus through the activities performed by the managers of it and its Indiana filing affiliates. However, this cannot be the case because of the statutory prerequisite that each entity in the consolidated group have income derived from Indiana sources as provided in IC § 6-3-4-14.

Seemingly, Taxpayer is making an argument that a taxpayer seeking to file a combined return would make in a petition to the Department as provided in IC § 6-3-2-2(l), (q). Under IC § 6-3-2-2(l), if a taxpayer feels "the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for... the employment of [another] method to effectuate an equitable allocation and apportionment of the taxpayer's income." (Emphasis added). However, Taxpayer has not petitioned for a combined return filing, thus, the issue here is consolidated returns. Consolidated returns only include affiliated entities with Indiana source income. Taxpayer's managers' activities do not show income, Indiana or otherwise, to the excluded entity, therefore, the activities are not eligible for consideration under IC § 6-3-4-14(a) and 45 IAC 3.1-1-111.

FINDING

Taxpayer's protest is denied.

SUMMARY

Taxpayer's protest to the imposition of tax resulting from the determination of its available 2006 net operating loss deduction that originated from an additional amount of net operating loss carried forward from the 2001 tax year, as the result of an RAR, is sustained in part, subject to the results of a supplemental audit, as discussed in Issue I subpart B. However, Taxpayer's protest for all other issues is denied.

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